DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0168
Indiana Sales and Use Tax
For the Tax Years 1998, 1999, and 2000

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ISSUES

I. **Natural Gas Utility Exemption** – Sales and Use Tax.

Authority: IC 6-2.5-2-1(a); IC 6-2.5-4-5(b); IC 6-2.5-4-5(c); IC 6-2.5-4-5(c)(3); Dept. of State Revenue v. Kimball International, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); 45 IAC 2.2-4-13(e).

Taxpayer argues that its purchase of natural gas should be exempt from the state's gross retail tax because the natural gas is "predominately used" in the production of tangible personal property.

II. **Abatement of the Ten-Percent Negligence Penalty**.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it is justified in requesting that the Department of Revenue (Department) exercise its discretion to abate the ten-percent negligence penalty assessed at the time of the audit report.

STATEMENT OF FACTS

Taxpayer is in the business of manufacturing and selling truck parts. Taxpayer manufacturers truck beds, tailgates, and suspension systems. The Department conducted a sales and use tax audit during which taxpayer's financial and utility consumption records were examined. The audit resulted in the assessment of additional use tax. The taxpayer disagreed with portions of the assessment and submitted a protest to that effect. In that initial protest letter, taxpayer challenged the audit's determination that taxpayer was not entitled to a sales and use tax exemption on the purchase of electricity used in taxpayer's Building Three and Building Four. This first issue was subsequently considered during a field audit. After reviewing the electrical use in Buildings Three and Four, the field audit agreed that "the meters are predominately exempt" and should be "allowed as 100 [percent] exempt rather than the calculations included in the audit." According to that field audit, "This issue should be adjusted in a supplemental audit after the [natural] gas issue is settled in hearing." The remaining portions of taxpayer's protest were discussed during an administrative hearing, and this Letter of Findings follows.

DISCUSSION

I. **Natural Gas Utility Exemption** – Sales and Use Tax.

Taxpayer maintains that it is entitled to a sales tax exemption on the purchase of natural gas used to heat four of its buildings. Each of the four buildings has a separate natural gas meter, taxpayer uses each of the four buildings for somewhat different purposes, and each of the four buildings will be considered here in turn.

Indiana imposes a gross retail (sales) tax on certain sales made within the state. IC 6-2.5-2-1(a). The tax is not imposed on all transactions but only those which constitute "retail transactions."

Sales of public utilities are specifically designated as "retail transactions." IC 6-2.5-4-5(b) states that, "A power subsidiary or a person engaged as a public utility is a *retail merchant* making a *retail transaction* when the subsidiary or person furnishes or sells electrical energy, natural or artificial gas, water, steam, or steam heating service to a person for commercial or domestic consumption." (*Emphasis added*).

However, the legislature has seen fit to allow a number of specific exemptions. *See* IC 6-2.5-5-1 et seq. The statute, designating utility transactions as "retail sales," refers to one of those exemptions. IC 6-2.5-4-5(c) states:

> Notwithstanding subsection (b), a power subsidiary or a person engaged as a public utility is not a retail merchant making a retail transaction when . . . (3) the power subsidiary or person sells the services or commodities listed in subsection (b) to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture. However, this exclusion for sales of the services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are *separately metered* for the excepted uses listed in this subdivision. (*Emphasis added*).

Therefore, if a widget manufacturer purchases electricity to operate its widget stamping machine, it is entitled to claim the sales tax exemption as long as there is a way of directly measuring (i.e. "metering') the electricity used by the particular widget stamper. However, taxpayer does not use its natural gas in a directly measurable way to produce its truck parts. Rather, taxpayer buys natural gas in order to provide heat for the four buildings. Instead, taxpayer relies on the language contained within IC 6-2.5-4-5(c)(3). That language permits a manufacturer of tangible personal property to claim the utility exemption "if those [utility] sales are not separately metered but are predominately used by the purchaser for the excepted uses listed in this subdivision."

Therefore, in order to successfully claim the exemption, taxpayer must demonstrate that the natural gas is "predominately used" to manufacture truck parts.

The Department has defined "predominantly used" as follows: "Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are predominantly used for excepted purposes. Predominant use shall mean that more than fifty percent (50%) of such utility services are consumed for excepted use." 45 IAC 2.2-4-13(e).

Building One:

Taxpayer accepts initial delivery of various grades of steel in Building One. In addition, the steel is cut in this building. According to taxpayer, the heat in this building must be maintained at an optimum temperature in order to assure that the temperature of both the steel and the cutting equipment remains consistent. Taxpayer offered a written statement from its steel supplier recommending that the temperature of the steel be maintained in order to "maintain the physical characteristics and dimensional stability of the steel."

Taxpayer also maintains that heating Building One to a consistent level is necessary because the cutting equipment is computer-controlled, and temperature variations will affect the performance of the cutting equipment. Taxpayer supplied a letter from the manufacturer of the computer-controlled cutting equipment. In that letter, the manufacturer states that, "We recommend the area in which our [computer-controlled equipment] is installed be maintained at a temperature no lower than 50 degrees." The letter goes on to state that, "testing has shown the accuracy of the unit to be outside the operational limits [manufacturer] requires for your specific application."

Taxpayer's argument – so far is it concerns Building One – is that taxpayer is entitled to the utility exemption for the natural gas measured at this building's meter because the natural gas is "predominately used" for an exempt purpose.

Building Two:

Taxpayer transfers the cut steel to Building Two. In that building, the steel is bent and wire-welded. According to taxpayer, both the "bending" and wire-welding are computer-controlled activities. If the temperature is not maintained, the steel cannot be consistently bent to the required specification. In other words, if a piece of steel having a temperature of 50 degrees was bent and a piece of steel having a temperature of 70 degrees was bent by the same automated machinery, the resulting two units of formed steel would be inconsistent. In addition, taxpayer states that the wire-welding process also requires that temperature in Building Two be maintained a constant level. According to taxpayer, variations in temperature would affect the steel's electrical resistance, and the resulting weld would be faulty.

Building Three:

After the steel is bent, formed, and welded, it is moved to Building Three where the partially-finished truck equipment is painted. According to taxpayer, its painting process requires that the temperature in Building Three be maintained at approximately 80 degrees. Taxpayer provided information from its paint supplier specifying that a temperature between 65 and 75 degrees be maintained. According to the paint supplier, "At this temperature range the most favorable paint flow and processing is provided." In addition, the paint supplier states that, "Too low workshop temperatures (under 60F/15C) and high humidity are detrimental to the result." Taxpayer states that if the ambient building temperature is too low, the paint will not "cure" properly.

Taxpayer bolsters its claim to the exemption for Building Three on the ground that the painting process requires that the air in Building Three be constantly exchanged with outside air. In its protest letter, taxpayer states that, "The large amount of gas usage [in Building Three] is required because IDEM requires that the air change every 48 seconds for the health of the employees." In addition, taxpayer offered information from its paint supplier indicating that – in order to

properly apply the paint – that, "Fresh air is constantly sucked in from the atmosphere and the used air is exhausted at another point."

The audit report rejected taxpayer's claim that it was entitled to the utility exemption for Building Three. In arriving at that conclusion, the audit report compared gas consumption during June, July, and August with gas consumption during the remainder of the year. Because the Building Three gas consumption during the summer months was extremely low – 2 cubic feet of gas – the audit concluded that taxpayer purchased the natural gas merely for general heating purposes. It is undisputed that the purchase of natural gas simply for the purpose of heating a building – even a building in which manufacturing takes place – is a non-exempt transaction under IC 6-2.5-4-5(b). However, taxpayer counters the audit's conclusion stating that a comparison of the amount of gas consumed in Building Three with the amount of gas consumed in two of its other buildings – in which the inside air is not exchanged with outside air – demonstrates that amount of gas consumed in Building Three is largely attributable to the painting activities which occur in that building. Taxpayer's otherwise unverified analysis concludes that the gas consumption in Building Three is approximately three times the amount consumed in a building having a comparable ceiling height and floor area. According to taxpayer, this comparison purports to demonstrate that approximately 87 percent of the gas used in Building Three is attributable to its exempt manufacturing activities.

Taxpayer adds a third argument stating that the computer-controlled painting equipment requires maintaining a certain temperature in order for the equipment to function properly.

Building Four:

The activities in Building Four are similar to the activities occurring in Building One and Building Two except that smaller items of equipment – such as suspension systems – are assembled in Building Four. In Building Four, taxpayer cuts, bends, and wire-welds steel. Again, computer-controlled fabricating equipment directs these activities. Again, taxpayer asserts that the proper functioning of the computer control devices requires the maintenance of a consistent, minimum temperature.

The Department concludes that taxpayer, under IC 6-2.5-4-5(c)(3), is entitled to the "predominately used" exemption for the natural gas metered for use in Building Three because taxpayer has demonstrated that the natural gas consumed in that particular building is "an essential and integral part of an integrated process that produces tangible personal property." Dept. of State Revenue v. Kimball International, Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). In Kimball, given the size of the size of the objects being painted, the manufacturer was able to limit its exempt painting activities within the confines of paint (or spray) booths. In this case, taxpayer has demonstrated that Building Three is acting as the taxpayer's own "paint booth." Given the large and unwieldy size of truck components being painted, taxpayer's decision to treat Building Three as an oversize paint booth and to heat and exchange the inside air accordingly, is entirely justifiable. Without natural gas heat and the constant exchange of room air, taxpayer's painting activities would not occur. Id. at 457. Similar to the manufacturer in Kimball, taxpayer has demonstrated that – but for the natural gas consumed in heating Building Three – the painting of taxpayer's truck parts could not and would not occur unless the entire building was heated to the degree and to the extent that it is. As in Kimball, taxpayer has demonstrated that, "from an operational standpoint," without the heating of Building Three – and the natural gas consumed thereby – the taxpayer's painting process would be not be possible. Id.

FINDING

Taxpayer's protest is sustained in part and denied in part. Taxpayer is entitled to the predominate use exemption for natural gas used in Building Three. Taxpayer is denied the predominate use exemption for Buildings One, Two, and Four.

II. Abatement of the Ten-Percent Negligence Penalty.

In its protest letter, taxpayer stated that it was entitled to abatement of the ten-percent negligence penalty on the ground that it "did not willfully disregard the law," that "[t]he omissions were due to error," and a "deficiency of .05% is hardly material."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The audit concluded that the ten-percent negligence penalty was appropriate because taxpayer substantially underpaid use tax in 1998 and 1999 and paid no use tax during 2000. Although – as taxpayer contends – the amount of the additional assessment may have been "negligible," the failure to calculate, self-assess, and pay the accrued use tax does not demonstrate the "ordinary business care and prudence" sufficient to warrant abating the penalty.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 032905